The Heritage Foundation

Energy Tax Reform Proposal

The Heritage Foundation believes that the entire U.S. tax system needs fundamental reform that moves aggressively toward a system like the New Flat Tax. Such a tax system would eliminate existing problems that arise from the bad habit of using the tax code to pick winners and losers in the energy marketplace, a habit that serves only special interests while distorting markets, misallocating resources, and ultimately hurting American businesses and families.

For more, see J. D. Foster, "The New Flat Tax—Easy as One, Two, Three," Heritage Foundation *Backgrounder* No. 2631, December 12, 2011, http://www.heritage.org/research/reports/2011/12/the-new-flat-tax-easy-as-one-two-three.

1.) **Exploration and production**

a.) What are the impacts of the current tax code on energy production and use?

Immediate Expensing. For exploration and production, companies have the ability to expense capital costs in the year of the purchases. Immediate expensing allows companies to deduct the cost of capital purchases at the time they occur rather than deducting that cost over many years based on cumbersome depreciation schedules. Expensing is the proper treatment of capital expenditures. Depreciation raises the cost of capital and discourages companies from hiring new workers and increasing wages for existing employees. Immediate expensing for all new plant and equipment costs—for any industry or type of equipment—would allow newer equipment to come online faster, which would improve energy efficiency and overall economic efficiency. Even President Obama has championed temporary 100 percent expensing for qualified capital because it lowers the cost of investment.

Section 199 Deduction. This tax deduction, under Internal Revenue Code Section 199, goes to all domestic manufacturing. Producers of clothing, roads, electricity, water, and many other goods produced in the United States are all eligible for the manufacturing tax deduction. The Section 199 deduction is supposed to be unavailable to the service sector, but manufacturing is so broadly defined that the tax deduction includes music and movie production. Removing oil and gas production eligibility for this tax break is not removing a subsidy or closing a tax loophole but imposing a targeted tax hike. In fact, Congress already imposed a tax hike on oil and natural gas companies by freezing the deduction at 6 percent when other manufacturers receive a 9 percent deduction.

Enhanced Oil Recovery (EOR) Tax Credit. Oil producers receive a 15 percent tax credit for costlier methods and technologies, such as injecting liquids and carbon dioxide into the earth. Many EOR processes are no longer in use, and the tax credit applies only when the price of oil falls below a certain level.

Marginal Well Production Credit. Marginal wells produce 15 or fewer barrels of oil per day, produce heavy oil, or produce mostly water and fewer than 25 barrels of oil per day. The marginal well production credit is another safety-net tax provision. This is another preferential tax credit that Congress should repeal.

b.) What changes would we recommend for a pro-growth tax code?

All companies, including oil and gas companies, should be able to expense their full capital costs immediately. Until that critical change in the tax code is made for all businesses, Congress should retain all provisions that move the tax code in the direction of expensing. Congress should make immediate expensing permanently available for all business investments.

c.) What questions should the committee be asking in reference to taxes and energy?

- Why do all manufacturers get to take a 9 percent deduction while oil and gas companies take a 6 percent deduction?
- Would you support removing the Section 199 deduction completely and lowering rates broadly as to not create a tax increase?
- Why does a broadly available tax credit or deduction count as a subsidy for an oil company but not anyone else?
- Do you believe taxpayers should help foot the bill when the price of a barrel falls below a price where wells are no longer economical?

For more, see Nicolas D. Loris and Curtis S. Dubay, "What's an Oil Subsidy?" Heritage Foundation *WebMemo* No. 3251, May 12, 2011, http://www.heritage.org/research/reports/2011/05/whats-an-oil-subsidy

2.) Renewable Energy

a.) What are the impacts of the current tax code on energy production and use?

The number of energy tax programs expanded from 11 in 1999 to 38 in President George W. Bush's 2007 budget. Using the tax code to provide preferential treatment to energy producers has a number of market-distorting effects. Not only do targeted tax credits misallocate labor and capital by shifting resources away from more competitive use, but they are significantly impacting the production and consumption of energy.

Rather than create a market in which the producer must innovate and lower costs to be competitive with other generating sources, companies spend more resources lobbying to receive these targeted tax credits. If a technology is profitable, however, the investments will occur with or without the subsidy. In that case, the subsidy offsets private-sector investments that would have been made anyway, and the taxpayer dollars are simply a generous handout to the company. Patrick Jenevein, CEO of the clean energy firm Tang Energy Group, affirmed in *The Wall Street Journal* the problems with his own industry's dependence on subsidies, stating, "Government subsidies to new wind farms have only made the industry less focused on reducing costs. In turn, the industry produces a product that isn't as efficient or cheap as it might be if we focused less on working the political system and more on research and development."[1]

b.) What changes would we recommend for a pro-growth tax code?

Removing the targeted tax credits for all energy sources and broadly lowering the tax rate, as Congressman Pompeo's Energy Freedom and Economic Prosperity Act does, would allow for a more market-based energy economy that benefits economically viable producers and, ultimately, consumers with reliable, affordable energy.

The legislation would benefit energy producers and consumers by eliminating economically unjustified tax credits for both conventional and renewable energy sources and technologies while lowering the corporate tax rate to encourage investment and spur economic growth.

Renewable energy projects are excluded from forming a Master Limited Partnership (MLP), which is currently available for oil, natural gas, mineral extraction, and pipeline projects. This would allow renewable energy companies to construct a business that is taxed as a partnership but whose ownership interests are traded like corporate stock. Congress should allow clean energy projects to form MLPs but also work to remove all of the other preferential treatment renewable energy companies receive through the tax code.

c.) What questions should the committee be asking in reference to taxes and energy?

- Doesn't giving renewable companies a leg up with the tax code provide government welfare and create government dependence?
- If these companies cannot compete without the targeted tax credit, do they deserve to be in the marketplace?
- If these companies can compete without the tax credit, why do we need it?

[1] Patrick Jenevein, "Wind-Power Subsidies? No Thanks," *The Wall Street Journal*, April 1, 2013, http://online.wsj.com/article/SB10001424127887323501004578386501479255158.html?mod=WSJ_Opinion_LEADTop%20 (accessed April 12, 2013).

- Many of these tax credits have been around for decades. How long does the "infant industry" argument last?
- What is the cost of these targeted tax credits to Americans as taxpayers and as ratepayers?
- What environmental good are these policies doing?
- Doesn't picking winners and losers through the tax code crowd out opportunities for more efficient technologies by directing labor and capital away from more productive use?
- Proponents of tax credits always argue they want certainty. Isn't the fact that these credits have a specific end date enough certainty?

For more, see Nicolas D. Loris, "EFEPA Eliminates Corporate Welfare and Corporate Dependence," Heritage Foundation *WebMemo* No. 3828, January 15, 2013, http://www.heritage.org/research/reports/2013/01/energy-tax-credits-impact-of-energy-freedom-and-economic-prosperity.

3.) Efficiency

a.) What are the impacts of the current tax code on energy production and use?

Included in the 2012 and 2013 federal tax credit are efficiency tax credits for biomass stoves, heating, ventilation and air conditioning, insulation, roofs, water heaters, windows, doors, geothermal heat pumps, residential windmills and solar energy systems.[2] Energy-efficiency tax credits, along with efficiency mandates, dictate how consumers make choices. When using these tax credits, they are using other peoples' money to do so.

Consumers already place a high value on saving money through efficiency, and markets already incentivize Americans to be more energy efficient. These tax credits and efficiency standards unnecessarily make energy savings a top preference for families even though families may have overriding preferences when it comes to buying new products (for example, a more safe vehicle or a dishwasher that runs a cycle in 75 minutes, not 130). They also face budget constraints when they make tough choices about how to spend their money. They have a rightful skepticism that, by Washington pushing certain "energy efficient" products on them, they will not actually save money or that the product may perform poorly.

A government survey of the Environmental Protection Agency's EnergyStar labeling program, which identifies energy-efficient products, found that 62 percent of households were either "very likely" or "somewhat likely" to buy the product without the

[2] Energy Star, Federal Tax Credits for Energy Efficiency, https://www.energystar.gov/index.cfm?c=tax_credits.tx_index (accessed April 12, 2013).

government handout. In effect, this means 38 percent felt the energy savings were not worth the additional cost of the product.

b.) What changes would we recommend for a pro-growth tax code?

Congress should remove all tax credits (and broadly lower rates to offset any tax increase) for energy efficiency purposes. Congress should also withhold funds or pass legislation that repeals efficiency standards and instead promotes voluntary programs such as EnergyStar, which provides consumers with information about energy savings for appliances.

c.) What questions should the committee be asking in reference to taxes and energy?

- Everyone calls energy efficiency savings low-hanging fruit for businesses and families, but if these energy savings investments are so great, why do we need to use other peoples' money to encourage buying them? Why do we need a program at all?
- Why should the government dictate which preferences matter most to families and businesses?
- If the overwhelming majority of projected benefits in regulatory impact analyses come from purported consumer savings and not from reduced emissions, is that not a clear indicator this is more about government micromanagement of the economy than reducing emissions?
- Would you agree that the federal government's involvement in the energy efficiency market (weatherization program, appliance efficiency standards) has led to waste, fraud, and abuse of taxpayer dollars and also created the unintended consequence of poor product performance that negates some of the energy savings?
- Would you agree that many of these products have to be owned for a very long time before the consumer will realize his savings from the higher upfront cost?

For more, see Nicolas D. Loris, "Energy Efficiency, Not Efficiency Mandates," Heritage Foundation *WebMemo* No. 3876, March 14, 2013, http://www.heritage.org/research/reports/2013/03/why-energy-efficiency-is-good-energy-efficiency-mandates-are-bad.